September 7, 2023

The Honorable Ron Wyden
Chairman
Committee on Finance
U.S. Senate
Washington, DC 20510

The Honorable Mike Crapo
Ranking Member
Committee on Finance
U.S. Senate
Washington, DC 20510

Proof of Stake Alliance Comments Regarding the Timing and Character of Income from Staking and Mining, in Response to the Request for Feedback from Senate Finance Committee Chairman Ron Wyden and Finance Committee Ranking Member Mike Crapo.

Dear Chairman Wyden and Ranking Member Crapo,

The Proof of Stake Alliance advocates for sensible policy relating to the newer "proof-of-stake" technology that allows every token holder to participate in validating transactions and adding blocks to cryptocurrency blockchains.

From its founding in 2019, POSA has focused on the proper taxation of so-called "block rewards," the new tokens that incentivize the public to participate in adding blocks and securing these decentralized networks. Most importantly, for reasons of both economic stability and legal consistency, **mining and staking rewards must be taxed at the time of their sale and exchange, not as immediate income at the time new cryptocurrency blocks and tokens are created.**

The alternative – taxing them as immediate income at the time of creation, plus a second time for any gain or loss at the time of the tokens' sale – is demonstrably unfair to taxpayers, administratively infeasible, and inconsistent with the established tax treatment of other property.

A fair and administratively feasible policy must:

Make tax compliance possible. A neutral and just tax code should not punish taxpayers for their choice of economic activity. New blocks and tokens are created every few seconds, day in and day out. Treating each block as a taxable event would make tax compliance extraordinarily complex for millions of taxpayers *and* the IRS.

Proof-of-stake technology democratizes participation in these networks and is more energy-efficient than proof-of-work mining. But perversely, this democratization magnifies these compliance costs as more cryptocurrency holders would face these burdens. Taxation-on-creation would discourage both Americans' participation in this technology and the compliance of those who do participate. Treating tokens as taxable upon sale, by contrast, is straightforward.

Ensure only taxpayer *gains* are taxed. Because everyone can participate in staking, the immediate taxation of staking rewards demonstrably overstates the taxpayer's economic gain from staking, resulting in unfair and economically senseless overtaxation. Taxing staking participants at the correct *time* – the time of their sale or exchange – ensures that only taxpayer *gains* are taxed, eliminating this overtaxation.[1]

[1] For a detailed case study of this overtaxation, using the facts from U.S. taxpayer and cryptocurrency staker Joshua Jarrett, see Mattia Landoni and Abraham Sutherland, *Dilution and True Economic Gain From Cryptocurrency Block Rewards*, Tax Notes Federal, Aug. 17, 2020, p. 1213, available at ssrn.com/abstract=3672461. A shorter version of this article is also available at https://www.coincenter.org/dilution-and-its-discontents-quantifying-the-overtaxation-of-block-rewards/.

The overstatement of economic gain means that the fair market value of new rewards tokens at the time they are created does *not* describe stakers' economic gain. Suppose a cryptocurrency starts with 1,000 tokens and block rewards add 100 new ones over the course of a year. If every token holder stakes and therefore ends the year with 10 percent more tokens, no staker has any economic gain from staking. In this simplified case, staking involves no gain at all; instead it prevents token holders from losing out. Taxing those 10 percent new tokens as income is as economically misguided as taxing the new shares of stock in an 11-for-10 stock split. New tokens dilute the value of *all* tokens. Treating new tokens as a realization event, but ignoring the offsetting dilution effect is economically indefensible.

Not all token holders participate in staking, but the overstatement of economic gain is real and, perversely, the overtaxation increases as a higher percentage of tokens participate in staking. Josh Jarrett, a Tezos staker, created 8,876 new tokens in 2019, with a fair market value of $9,404.[2] But that year, about 75 percent of all Tezos tokens were staked. The total supply of Tezos tokens increased by 5.06 percent, while Josh's tokens increased at a rate of 5.74 percent. Jarrett's new tokens therefore outweighed the dilution effect of all the new tokens – but not by much. There is no optimal way to run the calculations, but on the most accurate accounting method Josh's economic gain from staking was $1,458. Taxing Josh on $9,404 of "income" when his economic gain was a fraction of that – as the taxation-on-creation camp advocates – is indefensible. The income tax taxes *gains*. If it's not a gain, it should not be taxed.[3]

[2] For more on these calculations see *Dilution*, *supra* note 1, and also *Phantom Income and the Taxation of New Cryptocurrency Tokens*, Tax Notes Federal, January 30, 2023, p. 669, at 673, available at ssrn.com/abstract=4362822.

[3] Indeed, if it is not a gain, the tax law does not permit it to be taxed as income.

Tax cryptocurrency consistently with other property. Newly created property is *never* immediately taxable income. Whether it's a loaf of bread, mined minerals, or a screenplay, new property is taxed when it is sold or exchanged. Staking rewards should not be treated differently.

Of course, property received as payment or compensation from someone else can indeed be taxable income. But a decentralized cryptocurrency is not controlled by any person or entity, and to claim that computer software can create tokens and pay them to taxpayers misunderstands how cryptocurrency works. Regardless, taxing reward tokens like other new property resolves the fairness and administrative issues that would otherwise unreasonably discourage Americans from participating in this new technology.

Reduce the harm from liquidity constraints. Tokens are property but tax must be paid in U.S. dollars, not tokens. Token holders accept the potential risk and volatility of holding these assets, but should not be forced to continuously sell new tokens to ensure the dollar liquidity needed to pay tax. Staking protects against the dilution effect of new tokens; as shown in the analysis of overtaxation illustrated by taxpayer Josh Jarrett, staking rewards are not pure "gains" to begin with. If tokens are immediate income, taxpayers who stake and retain their tokens will face unreasonable consequences if the value of the cryptocurrency declines. The staker will have ordinary income from the new tokens, which cannot be set off against the later capital losses captured by the sale of those tokens.

Ensure correct taxation of capital gains and losses. Like any other property, whether a digital asset is a capital asset should depend on the taxpayer and how they use that asset. In most taxpayers' hands, tokens are capital assets. The staker who starts with 100 tokens and ends up with 105 through staking should receive the same tax treatment on all tokens. In clarifying the taxation of staking rewards, Congress should make clear that gains from newly created tokens will be of the same character as gains or losses from stakers' existing tokens.

Assert Congress's appropriate role in setting just tax policy. Congress should promptly pass legislation to clearly state that mining and staking rewards are taxed upon sale. POSA believes this result is already required by existing law, but recent events make Congressional action even more urgent.

Three years ago, when the IRS declined to confront this important issue, POSA supported taxpayer Joshua Jarrett's effort to get a court ruling on the taxation of his Tezos staking rewards. But instead of allowing the courts to provide much-needed clarity, the IRS tried to avoid a court ruling: in an attempt to make his case go away, it conceded Josh had overpaid his taxes but refused to concede Josh was right on the law.

Recently, on July 31, 2023 – just days after Josh's appeal was argued – the IRS published Revenue Ruling 2023-14. That guidance announces the IRS's position that "validation rewards" are stakers' immediately taxable income. But the guidance offers little analysis and conspicuously avoids key factual and legal considerations, casting doubt on its application to stakers such as Josh.[4] To the extent the ruling *is* clear, such subregulatory guidance does not have the force of law and indeed the courts will not defer to the IRS's conclusions. Far from resolving the issue, this IRS guidance further contributes to ongoing uncertainty, making prompt action by Congress all the more important.

[4] See Fenwick & West LLP, "IRS Issues Revenue Ruling 2023-14 on Staking," Aug. 1, 2023, https://www.fenwick.com/insights/publications/irs-issues-revenue-ruling-2023-14-on-staking.

Proposed Legislation

POSA proposes the following legislative text to codify the fair taxation of mining and staking rewards. This proposal follows the structure of the tax code, placing new provisions in Subchapter B, Part III (“Items specifically excluded from gross income”) and in Subchapter O (“Gain or loss on disposition of property”), Part II (“Basis rules of general application”).

Explanatory overview

“Sec. XXX (Digital Asset Mining and Staking) Declares that digital assets acquired through mining or staking activities do not form part of a taxpayer’s gross income but are taxable on disposition under normal income tax principles.”

Substantive provisions

Create new Tax Code section 139J:

“DIGITAL ASSET MINING AND STAKING.—Gross income does not include the value of property produced or received in connection with digital asset mining or staking activities.”

Create new Tax Code section 1023:

“BASIS OF PROPERTY PRODUCED OR RECEIVED IN CONNECTION WITH DIGITAL ASSET ACTIVITIES.—The basis of property not included in gross income under section 139J, for the purpose of determining gain or loss from its sale or other disposition, shall be the cost of such property.”

Conclusion

Mining and staking rewards should be taxed at the time of their sale and exchange, and taxable income so generated should retain the character (i.e., capital or ordinary) of the taxpayer's tokens acquired through other means. POSA and its advisers have written and advocated extensively on this issue, including detailed analyses of the points and arguments summarized here. Please contact us for further discussion.

Contact:

POSA Executive Director, Alison Mangiero – alison@proofofstakealliance.org

POSA Legal Advisor, Abraham Sutherland – abesutherland@gmail.com

Stable URL:

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